INTERNAL CONTROLS

Day 2

LEAD THE WAY

PHA GOVERNANCE AND FINANCIAL MANAGEMENT

A Training for Board Members and Staff

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

TABLE OF CONTENTS

Welcome to Day Two of *Lead the Way: PHA Governance and Financial Management.*

Who should complete this training?

This training is for all staff members of a public housing agency (PHA)—particularly those with any financial management responsibility. Typically this includes the Executive Director or the CEO, the Chief Financial Officer, Chief Operations Officer of administrator, other executive staff, program heads, including Housing Choice Voucher administrators, and any other staff interested or involved in the finances and oversight of the PHA You may complete this course with your colleagues from your PHA, or with other PHAs in your region.

How long will it take to complete and how should we structure our time?

The entire training should be completed over the course of five days. We recommend that there be no more than one day between Days One through Three, and no more than one week between Days Three through Five. Sample agendas for each day are provided for your reference. These agendas are meant to provide a reference of how much time should be spent on each lesson. However, different groups will have different needs. If a group feels the need to spend more time on a particular topic, they should do so.

Are there knowledge checks or quizzes?

Pre- and post-tests are provided, so that the group has a sense of where they could improve their knowledge, and to provide a measurement of the knowledge obtained in the training. These may be used to assess completion if certificates of completion are included. You should have completed a pre-test for Days 1-3 on Day 1.

How is this training facilitated?

It is recommended that you have a leader and a coordinator to shepherd the group through the process of the training. The leader either takes on the role of lead instructor, or hires someone to do so. The coordinator helps to obtain space for the training, sets up registration, ensures that the facility is accessible to people with special needs, takes notes, and is available to answer questions throughout the day. Both the leader and participants will use the same Training Guide. Leaders should also look at the notes provided in the Day One slides.

Are there PowerPoint slides?

Slides are provided for use in the training. We have noted the corresponding slide for each topic area in the text. Remember that these slides are samples, and can be adjusted according to your needs.

How do I use this training guide?

Participants can use the training guides to review the material ahead of the training. Information provided in these guides provides helpful contextual information and background to what will be presented on the PowerPoint slides. Participants should also keep their guides with them during the training, and follow along with the slide numbers.

01 Internal Controls and Financial Management

Agenda

8:30 a.m.	Check-In
8:45 a.m.	Module 1: Internal Controls on page 6
10:45 a.m.	Break
11:00 a.m.	Module 2: Implementation and Maintenance of Internal Controls Structures on page 17
12:15 p.m.	Lunch
1:15 p.m.	Module 3: Assessing and Mitigating Control Risks on page 24
2:15 p.m.	Break
2:30 p.m.	Module 4: The Impact of Internal Controls on Financial Statements and Reporting on page 32
4:30 p.m.	Class Ends

Purpose of Today's Training

Day 2, Slide 3

The objective of today's training is to provide an understanding of internal controls, including the roles and responsibilities of management, implementation and maintenance of internal controls structures, assessing and mitigating controls risks, the role of audits, and the impact of internal controls on financial statements and reporting.

02 Module 1: Internal Controls

Note: Slides 4-50 correspond with this module.

Module 1 Objectives

Day 2, Slide 52

At the conclusion of this module, you will understand:

- Internal controls
- The roles and responsibilities of management in internal controls

Internal Controls

Day 2, Slides 7-27

WHAT ARE INTERNAL CONTROLS?

Day 2, Slide 7

Internal controls address and minimize identified risks in key organization areas by establishing procedures and controls.

MANAGEMENT'S GENERAL ROLE IN INTERNAL CONTROLS

Day 2, Slides 8-9

Management should provide for reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

Although management has the primary responsibility for establishing a system of internal controls, the entity's governing board is ultimately responsible for ensuring that management staff fulfill their duty in establishing a system of internal controls.

Other examples of the board's oversight role in internal controls include discussing and/or reviewing with PHA management the following:

- Review of budget variance to ensure actual costs are in line with budget estimates
- Action on tenant accounts receivable
- The payment status for accounts payable
- Write-off of receivables to ensure all were board approved
- Bank statements to ensure all disbursements were approved, including electronic debits and cash withdrawals

- Credit card statements
- Petty cash reconciliations to verify all receipts are for valid expenses

WHY ARE INTERNAL CONTROLS IMPORTANT?

Day 2, Slide 10

An organization should be concerned with internal controls to protect its assets and reduce the risk of fraud.

INTERNAL CONTROL TRENDS

Day 2, Slide 11

Recent government-wide initiatives have also contributed to improvements in financial management and placed greater emphasis on implementing and maintaining effective internal control over financial reporting.

Internal Controls Components

Day 2, Slide 12

Internal controls include five key components:

- Control environment
- Risk assessments
- Control activities
- Information and communication
- Monitoring

CONTROL ENVIRONMENT

Day 2, Slides 13-16

Management and employees should establish and maintain an environment throughout the organization that sets a positive and supportive attitude toward internal control and conscientious management.

In a good control environment:

- Top management is fully committed to the importance of internal controls and demonstrates this by its actions.
- The organization has established benchmarks to measure its resource use and outcomes.
- Records are maintained in accordance with guidelines issued by the federal government.
- The organization has a contingency plan that addresses the absence of key employees and back-up procedures for key business processes.

RISK ASSESSMENTS

Day 2, Slides 17-20

Risk assessment refers to the identification, analysis, and management of uncertainty facing the organization. Focus in on the uncertainties in meeting the organization's:

- Financial objectives
- Compliance requirements
- Operational objectives

In assessing the risk in your organization, you should ask yourself:

- Is fiscal staff familiar with the rules and regulations regarding finance and accounting?
- Has fiscal staff been appropriately trained in the use of the accounting system, including the chart of accounts and edits?
- Has fiscal staff been appropriately trained in the use of the systems reports and reporting tools?
- Does fiscal staff possess basic accounting skills and knowledge necessary to adequately perform their responsibilities?

CONTROL ACTIVITIES

Day 2, Slides 21-25

Internal control activities are the policies and procedures—as well as the daily activities—that occur within an internal control system to minimize risk. There are five control activity types:

Preventive controls: To limit the possibility of an undesirable outcome being realized.

Corrective controls: To correct undesirable outcomes that have been realized.

Directive controls: To ensure that a particular outcome is achieved or an undesirable event is avoided.

Detective controls: To identify undesirable outcomes "after the event."

Performance controls: To orientate and motivate the organization's people to focus on the achievement of targets that are appropriate for the achievement of objectives.

INFORMATION AND COMMUNICATION

Day 2, Slide 26

Information and communication encompasses the identification, capture, and exchange of financial, operational, and compliance information in a timely manner.

People within an organization who have timely and reliable information are better suited to conduct, manage, and control the organization's operations.

MONITORING

Day 2, Slide 27

Just as control activities help to ensure that risk management actions are carried out, monitoring helps to ensure that control activities and other planned actions to affect internal controls are executed in a proper and timely manner. Ongoing monitoring activities evaluate and improve the design, execution, and effectiveness of internal control.

Internal Controls Review

Day 2, Slides 28-29

In assessing internal controls, practical areas for consideration include:

- Segregation of duties
- Bank reconciliation
- Supporting documentation
- Employees
- Safeguarding assets

SEGREGATION OF DUTIES

Day 2, Slides 30-31

Certain accounting and bookkeeping functions are designed to cross-reference each other for accuracy. If the same person is responsible for multiple duties, the natural checks and balance of your financial system is compromised.

Giving a single person unbridled authority over your resources is not a wise practice.

BANK RECONCILIATIONS

Day 2, Slide 32

Bank statements can only help you find discrepancies if they are reviewed in a timely manner. At a minimum, bank statements should be reconciled once a month.

SUPPORTING DOCUMENTATION

Day 2, Slide 33

Never sign checks, or any other document for that matter, without reviewing the supporting information. Though federal employees and grantees often face a hectic work environment, it is not a wise practice to “take someone’s word for it.”

SAFEGUARDING ASSETS

Day 2, Slide 34

Safeguarding the organization's assets includes small tasks such as:

- Locking up blank checks
- Depositing all cash and checks daily
- Password-protecting all of your sensitive electronic data
- Maintaining an inventory list of office furniture, electronics, etc.
- Ensuring you have adequate insurance coverage for all of your assets

HUD INTERNAL CONTROLS

Day 2, Slides 35-36

All HUD grantees are required to establish internal controls. Internal controls are the plans, methods, and procedures adopted by management to help PHAs manage financial assets and adhere to an approved budget. Internal controls help to prevent and detect loss of funds that the PHA could otherwise use for housing.

HUD Internal Controls, as it relates to Financial Management internal controls, is divided into six basic functions:

- Payroll
- Revenue
- Expenditure
- Property
- Treasury/Cash Management
- Financial Reporting

Internal Controls Deficiencies

Day 2, Slides 37-39

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis.

There are several types of internal control deficiencies, including:

- Control deficiencies
- Design deficiencies
- Operation deficiencies

Control deficiencies exist when the operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

A design deficiency exists when a control necessary to meet the control objective is missing or an existing control is not properly designed, so that even if the control operates as designed, the control objective is not always met.

An operation deficiency exists when a properly designed control does not operate as designed or when the person performing the control is not qualified or properly skilled to perform the control effectively.

GROUP EXERCISE—Internal Controls

Day 2, Slide 40

DIRECTIONS

Divide into groups based upon program area. Review the exercise and discuss the questions posed. Select one person per group to be the reporter and share your observations with the class. The exercise should take approximately 10 minutes of group work, and 10 minutes to report-out time.

Identify one potential deficiency under each category:

1. Control deficiency
2. Design deficiency
3. Operation deficiency

MANAGEMENT'S ROLE IN INTERNAL CONTROLS

Day 2, Slides 41-44

Management has a fundamental responsibility to develop and maintain effective internal control. The proper stewardship of federal resources is an essential responsibility of an organization's managers and staff.

A successful internal control environment requires management's commitment and support. Management's goal is not to make each person an expert in internal controls, but to increase awareness and understanding of why we need them and how we use them.

Managers must take systematic and proactive measures to:

- Develop and implement appropriate, cost-effective internal control for results-oriented management.
- Assess the adequacy of internal control in programs and operations.
- Separately assess and document internal control over financial reporting.
- Identify needed improvements.
- Take corresponding corrective action.

- Report annually on internal control through management assurance statements.

GRANTEES' ROLES

Day 2, Slide 45

Grantee programs must operate and resources must be used consistent with agency missions, in compliance with laws and regulations, and with minimal potential for risk, waste, fraud, and mismanagement.

DOES YOUR ORGANIZATION HAVE EFFECTIVE INTERNAL CONTROLS?

Day 2, Slides 46-47

With this new information, you have effective internal controls if:

- Your organization has developed and communicated rules of operations to employees and members.
- Follow-up is done to ensure expectations are met.
- Financial duties are properly segregated.
- The accounting system tracks grant and matching funds separately.
- The accounting system is used to create financial reports.
- Proper safeguards over assets exist.

Module 1 Knowledge Check

This knowledge check should be completed at the end of Module 1. Participants should circle their chosen answer. Leaders should review the correct answer using the following answer key once participants complete the knowledge check.

1. Internal controls are devised to do all but:
   a) Increase effectiveness and efficiency of operations
   b) Control staff with an iron fist
   c) Ensure reliability of financial reporting
   d) Ensure compliance with applicable laws and regulations
2. Internal controls are the responsibility of everyone but:
   a) Management
   b) Staff
   c) Contractors
   d) Federal agencies with oversight of programs
3. Internal controls remove identified risks in key organization areas by establishing procedures and controls.
   a) True
   b) False
4. In assessing internal controls, practical areas for consideration include:
   a) Bank reconciliation
   b) Supporting documentation
   c) Safeguarding assets
   d) All of the above
5. Mitigating risk will ensure that nothing goes wrong.
   a) True
   b) False
6. The various control deficiencies include:
   a) A design deficiency
   b) An operation deficiency
   c) A control deficiency
   d) All of the above
7. You should not put your organization's internal controls in writing.
   a) True
   b) False

8. The three objectives of internal control are all but:
    a) Efficient operations
    b) Audit-proofing the books
    c) Reliable financial reporting
    d) Compliance with laws and regulations

Stop: Do not proceed until the training Leader prompts you to turn the page.

Module 1 Knowledge Check

Answer key

Correct answers are indicated in ***bold***.

1. Internal controls are devised to do all but:
   a) Increase effectiveness and efficiency of operations
   b) ***Control staff with an iron fist***
   c) Ensure reliability of financial reporting
   d) Ensure compliance with applicable laws and regulations
2. Internal controls are the responsibility of everyone but:
   a) Management
   b) Staff
   c) ***Contractors***
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3. Internal controls remove identified risks in key organization areas by establishing procedures and controls.
   a) True
   b) ***False***
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   a) Bank reconciliation
   b) Supporting documentation
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   a) Efficient operations
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   d) Compliance with laws and regulations

03 Module 2: Implementation and Maintenance of Internal Controls Structures

Note: Slides 49-70 correspond to this module.

Module 2 Objectives

Day 2, Slide 50

At the conclusion of this module, you will understand:

- The implementation of internal controls
- The maintenance of internal controls

The Implementation of Internal Controls

Day 2, Slides 51-52

Effective implementation of internal controls gives reasonable assurance—not a guarantee—that all of the organization's business objectives will be achieved. Implementing internal controls extends way beyond ensuring that financial reports are reliable. Rather, it includes the efficient achievement of operational objectives and ensuring that the organization complies with laws, regulations, and policies.

Internal control is not one event, but a series of actions and activities that occur throughout an organization's operations on an ongoing basis. Internal control should be recognized as an integral part of each system that management uses to regulate and guide its operations.

Developing Internal Controls

Day 2, Slides 53-55

Internal controls are formal operating policies and procedures for mitigating risk.

These are calculated, discussed, refined, and incorporated into how an organization operates.

INTERNAL CONTROL DOCUMENTS

Day 2, Slide 56

With the establishment of formal written internal control documents, management can:

- Create and expand guidance for implementation of the controls
- Reduce the risk of errors and fraud
- Focus on high-risk areas in order to lessen the chances of errors and fraud
- Examine conflicting policies and duties (i.e., segregation of duties issues)

- Provide a system to create cross-training procedures
- Provide support for operational and performance decisions

The internal control document(s) should be continuously reviewed and updated for changes within an organization's environment. Then, regular internal audits are needed to ensure that personnel are aware of the internal controls procedures and the process requirements that it documents. Writing internal control procedures without the necessary awareness and follow-up is counterproductive.

WRITING INTERNAL CONTROL PROCEDURES

Day 2, Slides 57-61

When drafting your internal control procedures, follow these rules to ensure that your controls will operate properly:

Keep It Simple

Day 2, Slide 57

Internal control policies should document the overall process being executed. It is not necessary to document every single detail of every single action. Including minutia and too many details leads to an overly long and confusing accounting document, which ensures that your accounting procedure will be neither used nor followed.

Be Consistent

Day 2, Slide 58

Internal control policies should be consistent in format and design, including the use of key terms. They should be highly recognizable and familiar in an organization and not so technical that they render themselves useless.

Use More Than Text

Day 2, Slide 59

Why create internal control policies that rely solely on text? Graphics can illustrate accounting process flow, inputs/outputs, and important relationships or risks. As they say, a picture can be worth a thousand words; using graphics can improve simplicity and usability, which can lead to better internal control.

Keep Accounting Procedures Up To Date

Day 2, Slide 60

Keeping accounting procedures up to date means you are properly maintaining the internal control system. A change in the process means a change in the accounting procedure. If not evaluated regularly and modified, accounting procedures do not truly monitor the effectiveness of the accounting process or provide the needed internal controls.

INTEGRATION

Day 2, Slide 61

Internal controls should be built "into," not "onto," an organization's financial processes.

WHEN ARE INTERNAL DOCUMENTS SUFFICIENT?

Day 2, Slide 62

The internal control documentation may be considered sufficient when:

- Specific risks of errors or fraud in the process are identified
- Preventive controls are designed and put in place
- A person or group assumes responsibility for the process
- Written evidence is available to support the process

Management's Responsibility in Relation to Internal Controls

Day 2, Slides 64-70

Management has primary responsibility for assessing and monitoring controls, and should use other sources as a supplement to—not a replacement for—its own judgment.

Managers should continuously monitor and improve the effectiveness of internal control associated with their programs. Certain "tools" can help management maintain their internal control procedures:

- Management's knowledge gained from the daily operation of agency programs and systems
- Management reviews conducted (i) expressly for the purpose of assessing internal control, or (ii) for other purposes with an assessment of internal control as a by-product of the review
- HUD's Office of Inspector General and the U.S. Government Accountability Office (GAO) reports, including audits, inspections, reviews, investigations, outcome of hotline complaints, or other products
- Program evaluations

Internal control assessments should be a component of routine management and/or program reviews.

In addition, managers and staff should be encouraged to identify control deficiencies, as this reflects positively on the organization's commitment to recognizing and addressing management problems.

Failing to report a known reportable condition would reflect adversely on the organization and continue to place the organization's operations at risk.

Once they have learned of a reportable deficiency, management should carefully consider whether systemic weaknesses exist that adversely affect internal control across organizational or program lines.

Module 2 Knowledge Check

This knowledge check should be completed at the end of Module 2. Participants should circle their chosen answer. Leaders should review the correct answer using the following answer key once participants complete the knowledge check.

1. Effective implementation of internal controls guarantees that all of the organization's business objectives will be achieved.
   a) True
   b) False
2. Internal control should be recognized as a separate system that management uses to regulate and guide its operations.
   a) True
   b) False
3. With the establishment of formal written internal control documents, management can do all of the below except:
   a) Create and expand guidance for implementation of the controls
   b) Prove that their system is working
   c) Reduce the risk of errors and fraud
   d) Focus on high-risk areas in order to lessen the chances of errors and fraud
4. Writing internal control procedures without the necessary awareness and follow-up is:
   a) Dangerous
   b) Misguided
   c) Counterproductive
   d) All of the above
5. An organization's internal control documentation may be considered insufficient when:
   a) A person or group assumes responsibility for the process
   b) Specific risks of errors or fraud in the process are identified
   c) Preventive controls are designed and put in place
   d) They remain in place for too long without assessment
6. Management should use other sources as a supplement to—not a replacement for—its own judgment.
   a) True
   b) False
7. Management should assess internal controls in every single evaluation it conducts.
   a) True
   b) False

8. Managers and staff should be encouraged to identify control deficiencies.
   a) True
   b) False

9. Reporting of a deficiency would reflect adversely on the organization.
   a) True
   b) False

10. When mitigating risk, one should start with the smallest risk and work up to facing the greatest risk.
    a) True
    b) False

Stop: Do not proceed until the training Leader prompts you to turn the page.

Module 2 Knowledge Check

Answer Key

Correct answers are indicated in ***bold***.

1. Effective implementation of internal controls guarantees that all of the organization's business objectives will be achieved.
   a) True
   b) ***False***

2. Internal control should be recognized as a separate system that management uses to regulate and guide its operations.
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   a) A person or group assumes responsibility for the process
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8. Managers and staff should be encouraged to identify control deficiencies.
   a) ***True***
   b) False
9. Reporting of a deficiency would reflect adversely on the organization.
   a) ***True***
   b) False
10. When mitigating risk, one should start with the smallest risk and work up to facing the greatest risk.
   a) True
   b) ***False***

04 Module 3: Assessing and Mitigating Control Risks

Note: Slides 71-99 correspond with this module.

Module 3 Objectives

Day 2, Slide 72

At the conclusion of this module, you will understand:

- Assessing and mitigating control risks

What is a Control Risk?

Day 2, Slides 75-76

A control risk is the threat that an event or action (including non-action) will adversely affect an organization's ability to achieve its business objectives and execute its financial strategies successfully.

Control risk identification methods may include:

- Qualitative and quantitative ranking activities
- Management conferences
- Forecasting and strategic planning

QUALITATIVE AND QUANTITATIVE RANKING ACTIVITIES

Day 2, Slides 77-79

Both qualitative and quantitative tools are available to assist in determining the level of risk associated with an organization's operations.

A qualitative risk assessment is usually conducted through a combination of questionnaires and collaborative workshops involving people from a variety of groups within the organization.

What differentiates qualitative risk assessment from quantitative risk assessment is that the former does not try to assign hard financial values to assets, expected losses, and cost of controls.

Quantitative risk assessment comes into play when an organization has the ability to map a dollar amount to a specific risk. For example, it would cost $250 to purchase a shredder, whereas the cost of releasing confidential information is immeasurable (but likely a lot more than $250).

MANAGEMENT MEETINGS

Day 2, Slide 80

Management must meet often and regularly with risk management on its mind. This includes top management constantly examining how the organization's overall financial systems work to avoid risk (or implementing a system of "checks and balances").

FORECASTING AND STRATEGIC PLANNING

Day 2, Slide 81

Using the same forecasting techniques employed while creating its strategic plan, an organization must be able to look into the future and, as much as possible, plan for mitigating the areas that carry the greatest risks.

For instance, if the federal budget has been reduced dramatically in any given year, an organization may face reduced funding.

PRIORITIZING RISKS

Day 2, Slide 82

In ideal risk management, a prioritization process is followed.

- The risks with the greatest loss (or impact) and the greatest probability of occurring are handled ***first***.
- Risks with lower probability of occurrence and lower loss are handled in ***descending*** order.

Risk Management

Day 2, Slides 83-85

The focus of good risk management is the identification and treatment of risks. A good risk management process involves:

- Methodically identifying the risks surrounding your business activities
- Assessing the likelihood of an event occurring
- Understanding how to respond to these events
- Putting systems in place to deal with the consequences
- Monitoring the effectiveness of your risk management approaches and controls

This helps you allocate capital and resources more efficiently and significantly improves the probability that you will deliver your services on time and in accordance with your budget.

How Internal Controls Mitigate Risk

Day 2, Slides 86-89

Internal controls ensure that risk is mitigated through certain methods and procedures that implement a "checks and balance" system.

A precondition to risk mitigation is the establishment of clear, consistent objectives. Mitigating risk includes the identification and analysis of relevant risks associated with achieving the organization's objectives.

Management needs to comprehensively identify risks and should consider all significant interactions between the entity and other parties, as well as internal factors at both the entity-wide and activity level.

Common Financial Risks

Day 2, Slide 90

There are two common financial risks that pose the most serious threats to an organization's livelihood. These include allowing a financial loss and the misuse of funds.

ALLOWING A FINANCIAL LOSS

Day 2, Slides 91-92

A financial loss can have a tremendous impact on an organization. The loss of money can create a cash flow crunch and force the organization to reduce its spending, including eliminating staff or reducing the hours worked and minimizing the services offered to clients.

Besides reduced services, the organization may experience negative publicity about the incident. Lastly, a financial loss can affect the reputations of the people involved. Often, the board dismisses an executive director if a large theft occurs on his or her "watch."

MISUSE OF FUNDS

Day 2, Slide 93

All nonprofits exist for a specific purpose with a defined mission. Management is responsible for ensuring that the organization stays focused on its mission. An excellent way to monitor an organization's progress is through its use of funds.

Many HUD grantees receive funding with restrictions or limitations on its use. The improper use of these funds can cause HUD to withdraw the money, require repayment of the expended funds, and refuse to provide future funding.

The Role of Audits in Mitigating Risk

Day 2, Slides 94-98

Audits are unbiased financial examinations of an organization's accounts by a trained accountant or CPA. Audits are performed to ascertain the soundness and reliability of information, including an assessment of an organization's internal controls.

Conducting both internal and external financial audits allow an organization to examine what may be going awry in its operations.

This knowledge will, in turn, allow an organization to identify potential risks and implement corrective measures to ***avoid*** risks. In the worst-case scenario, an audit will allow management to ***address*** risks that pose a serious threat to an organization's financial operations.

Module 3 Knowledge Check

This knowledge check should be completed at the end of Module 3. Participants should circle their chosen answer. Leaders should review the correct answer using the following answer key once participants complete the knowledge check.

1. A control risk can be a "non-action."
   a) True
   b) False
2. Risk identification methods may include:
   a) Forecasting and strategic planning
   b) Qualitative and quantitative ranking activities
   c) Manager meetings
   d) All of the above
3. What differentiates qualitative risk assessment from quantitative risk?
   a) Qualitative risk assessment does not try to assign hard financial values to assets, expected losses, and cost of controls
   b) Quantitative risk assessment utilizes an organization's staff
   c) Quantitative risk assessment is when an organization has the ability to map a dollar amount to a specific risk
   d) All of the above
4. In ideal risk management, the risks with the greatest loss (or impact) and the greatest probability of occurring are handled first, and the risks with lower probability of occurrence and lower loss are handled in descending order.
   a) True
   b) False
5. The focus of good risk management is the identification and treatment of risks.
   a) True
   b) False
6. Internal controls do not include a "checks and balance" system.
   a) True
   b) False
7. Two common financial risks that pose serious threats to an organization are allowing a financial loss and the misuse of funds.
   a) True
   b) False

8. A financial loss may prompt all but:
   a) The elimination of staff
   b) Fewer services offered to clients
   c) Relief of the organization’s performance expectations
   d) Reduction of hours worked
9. The improper use of funds can cause HUD to require repayment of the expended funds.
   a) True
   b) False

Stop: Do not proceed until the training Leader prompts you to turn the page.

Module 3 Knowledge Check

Answer Key

Correct answers are indicated in ***bold***.

1. A control risk can be a "non-action."
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2. Risk identification methods may include:
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4. In ideal risk management, the risks with the greatest loss (or impact) and the greatest probability of occurring are handled first, and the risks with lower probability of occurrence and lower loss are handled in descending order.
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5. The focus of good risk management is the identification and treatment of risks.
   a) ***True***
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6. Internal controls do not include a "checks and balance" system.
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   b) False

05 Module 4: The Impact of Internal Controls on Financial Statements and Reporting

Note: Slides 100-112 correspond with this module.

Module 4 Objectives

Day 2, Slide 101

At the conclusion of this module, you will understand:

- The impact of internal controls on financial statements and reporting

The Current Environment

Day 2, Slides 102-103

In the wake of national corporate scandals, internal controls over reporting financial data have become a "hot" topic. The public now has a negative association with weak internal controls knowing that the same can allow for altered financial data.

Public and private stakeholders want to ensure that an organization's financial reports are truthful and allow one to see the entire financial picture of an organization, including reporting deficiencies in internal control; fraud; noncompliance with provisions of laws, regulations, contracts, and grant agreements; and abuse.

Purpose of Internal Control Over Financial Reporting

Day 2, Slides 104-105

An overall purpose of internal control over financial reporting is to facilitate the preparation of reliable financial statements. Reliable financial statements must be materially accurate in all respects.

Internal control over financial reporting is a formal system of checks and balances, monitored by management and reviewed by an outside auditor.

Internal control over financial reporting serves many goals, including:

- Identifying material weaknesses
- Bringing issues to light early
- Ensuring compliance with industry standards
- Employing competent personnel
- Allowing for fewer "spot-checks" during an audit
- Holding public organizations to the standards of private best practices

IDENTIFYING MATERIAL WEAKNESSES

Day 2, Slide 105

A key purpose of the assessment of an internal control over financial reporting is to identify material weaknesses that have ***more than a remote likelihood of leading to a material misstatement in the financial statements.*** Organizations with internal control problems, on average, have lower operating efficiency and produce lower quality financial reports.

BRINGING ISSUES TO LIGHT (EARLY)

Day 2, Slide 106

Effective internal control over financial reporting can also help companies deter fraudulent financial accounting practices.

Solid internal control policies will bring these deficiencies to light because they are in place, allowing financial reporting to detect them earlier and perhaps reduce their adverse effects.

ENSURING COMPLIANCE WITH INDUSTRY STANDARDS

Day 2, Slide 107

Internal control over financial reporting is designed by management to provide reasonable assurance of financial reporting and the preparation of financial statements in accordance with the Generally Accepted Accounting Principles (GAAP).

PERSONNEL

Day 2, Slide 108

To maintain effective internal control over financial reporting, an organization needs to retain individuals who are competent in financial reporting and related oversight roles.

Smaller organizations may address their needs for financial reporting competencies through engaging outside professionals to ensure proper internal controls over financial reporting.

MAINTENANCE OF PROPER EFFECTIVE INTERNAL CONTROLS

Day 2, Slide 109

There is an important relationship between the maintenance of proper effective internal control over financial reporting. If internal controls over financial reporting are adequate, an organization is not subject to as many financial tests (or “spot checks”) that would otherwise be required.

The reverse is true as well—if an internal control over financial reporting is not adequate, an organization must participate in more testing of its financial systems and statements to uncover deficiencies.

SIMILARITY TO PRIVATE RULES

Day 2, Slide 110

The financial management community has concluded that grantees should adhere to the same high standards expected of corporate managers with shareholders.

Therefore, public entities now utilize the Generally Accepted Accounting Procedures (GAAP) and incorporate guidance from the Federal Accounting Standards Board (FASB).

MONITORING INTERNAL CONTROL OVER FINANCIAL REPORTING

Day 2, Slide 111

Organizations are responsible for ***continuously*** monitoring and improving the effectiveness of internal control over financial reporting and compliance with applicable laws and regulations.

Module 4 Knowledge Check

This knowledge check should be completed at the end of Module 4. Participants should circle their chosen answer. Leaders should review the correct answer using the following answer key once participants complete the knowledge check.

1. Due to heightened knowledge of the benefits of internal controls over financial reporting, the public now demands that organizations provide clear financial statements and reports.
   a) True
   b) False
2. An overall purpose for internal controls over financial reporting is to facilitate the preparation of fancy financial statements.
   a) True
   b) False
3. Internal control over financial reporting serves many goals, except:
   a) Identifying material weaknesses
   b) Guaranteeing total compliance
   c) Bringing issues to light early
   d) Ensuring compliance with industry standards
4. A material weakness is an event that will lead to a material misstatement in the financial statements.
   a) True
   b) False
5. To maintain effective internal control over financial reporting, an organization needs to have in-house expertise in financial reporting and related oversight roles.
   a) True
   b) False
6. If internal controls over financial reporting are adequate, an organization is likely to have many financial tests (or “spot checks”).
   a) True
   b) False
7. Organizations should periodically monitor the effectiveness of internal control over financial reporting and compliance with applicable laws and regulations.
   a) True
   b) False

Stop: Do not proceed until the training Leader prompts you to turn the page.

Module 4 Knowledge Check

Answer Key

Correct answers are indicated in ***bold***.

1. Due to heightened knowledge of the benefits of internal controls over financial reporting, the public now demands that organizations provide clear financial statements and reports.
   a) ***True***
   b) False

2. An overall purpose for internal controls over financial reporting is to facilitate the preparation of fancy financial statements.
   a) True
   b) ***False***

3. Internal control over financial reporting serves many goals, except:
   a) Identifying material weaknesses
   b) ***Guaranteeing total compliance***
   c) Bringing issues to light early
   d) Ensuring compliance with industry standards

4. A material weakness is an event that will lead to a material misstatement in the financial statements.
   a) True
   b) ***False***

5. To maintain effective internal control over financial reporting, an organization needs to have in-house expertise in financial reporting and related oversight roles.
   a) True
   b) ***False***

6. If internal controls over financial reporting are adequate, an organization is likely to have many financial tests (or "spot checks").
   a) True
   b) ***False***

7. Organizations should periodically monitor the effectiveness of internal control over financial reporting and compliance with applicable laws and regulations.
   a) ***True***
   b) False

Appendix: Day 2 Checklist—Internal Controls and Financial Management

1. **Internal controls** address and minimize identified risks in key organization areas by establishing procedures and controls.

2. **Management** should provide for reasonable assurance that the following objectives are being achieved:
   - ✓ Effectiveness and efficiency of operations
   - ✓ Reliability of financial reporting
   - ✓ Compliance with applicable laws and regulations

3. **Internal controls** include:
   - ✓ A control environment
   - ✓ Risk assessments
   - ✓ Control activities
   - ✓ Information and communication
   - ✓ Monitoring

4. The five **control activities** include:
   - ✓ Preventive controls
   - ✓ Corrective controls
   - ✓ Directive controls
   - ✓ Detective controls
   - ✓ Performance controls

5. In **assessing internal controls,** practical areas for consideration include:
   - ✓ Segregation of duties
   - ✓ Bank reconciliation
   - ✓ Supporting documentation
   - ✓ Employees
   - ✓ Safeguarding assets

6. A **deficiency in internal control exists** when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis.

7. There are **three types of major deficiencies:**
   - ✓ Control deficiencies
   - ✓ Design deficiencies
   - ✓ Operational deficiencies

8. **Managers must take systematic and proactive measures** to:
   - ✓ Develop and implement appropriate, cost-effective internal control for results-oriented management
   - ✓ Assess the adequacy of internal control in programs and operations
   - ✓ Separately assess and document internal control over financial reporting
   - ✓ Identify needed improvements
   - ✓ Take corresponding corrective action

9. **Grantee programs** must operate:
   - ✓ Consistent with agency missions
   - ✓ In compliance with laws and regulations
   - ✓ With minimal potential for risk, waste, fraud, and mismanagement

10. Your organization has **effective internal controls** if:
    - ✓ Your organization has developed and communicated rules of operations to employees and members.
    - ✓ Follow-up is done to ensure expectations are met.
    - ✓ Financial duties are properly segregated.
    - ✓ The accounting system tracks grant and matching funds separately.
    - ✓ The accounting system is used to create financial reports.
    - ✓ Proper safeguards over assets exist.

11. **Effective implementation of internal controls** gives reasonable assurance—not a guarantee—that all of the organization's business objectives will be achieved.

12. With the **establishment of formal written internal control documents,** management can:
    - ✓ Create and expand guidance for implementation of the controls
    - ✓ Reduce the risk of errors and fraud
    - ✓ Focus on high-risk areas in order to lessen the chances of errors and fraud
    - ✓ Examine conflicting policies and duties (i.e., segregation of duties issues)
    - ✓ Provide a system to create cross-training procedures
    - ✓ Provide support for operational and performance decisions

13. When **drafting your internal control procedures,** follow these rules to ensure that your controls will operate properly:
    - ✓ Keep it simple.
    - ✓ Be consistent.

- ✓ Use more than text.
- ✓ Keep accounting procedures up to date.
- ✓ Integrate procedures into everyday policies and procedures.

14. The **internal control documentation may be considered sufficient** when:
    - ✓ Specific risks of errors or fraud in the process are identified
    - ✓ Preventive controls are designed and put in place
    - ✓ A person or group assumes responsibility for the process
    - ✓ Written evidence is available to support the process

15. Management has primary responsibility for assessing and monitoring controls, and should use other sources as a **supplement to—not a replacement for**—its own judgment.

16. Certain **"tools" can help management maintain their internal control procedures,** including:
    - ✓ Management's knowledge gained from the daily operation of agency programs and systems
    - ✓ Management reviews conducted (i) expressly for the purpose of assessing internal
    - ✓ control, or (ii) for other purposes with an assessment of internal control as a byproduct of the review
    - ✓ IG and GAO reports, including audits, inspections, reviews, investigations, outcome of hotline complaints, or other products
    - ✓ Program evaluations

17. **Managers' responsibilities when finding a control deficiency** include:
    Carefully considering whether systemic weaknesses exist that adversely affect internal control across organizational or program lines

18. A **control risk** is the threat that an event or action (including non-action) will adversely affect an organization's ability to achieve its business objectives and execute its financial strategies successfully.

19. **Control risk identification methods** may include:
    - ✓ Qualitative and quantitative ranking activities
    - ✓ Management conferences
    - ✓ Forecasting and strategic planning

20. In **ideal risk management,** a prioritization process is followed:
    - ✓ The risks with the greatest loss (or impact) and the greatest probability of occurring are handled ***first***.
    - ✓ Risks with lower probability of occurrence and lower loss are handled in ***descending order***.

21. The focus of **good risk management** is the identification and treatment of risks. A good risk management process involves:
    - ✓ Methodically identifying the risks surrounding your business activities
    - ✓ Assessing the likelihood of an event occurring
    - ✓ Understanding how to respond to these events
    - ✓ Putting systems in place to deal with the consequences
    - ✓ Monitoring the effectiveness of your risk management approaches and controls

    This helps you allocate capital and resources more efficiently and significantly improves the probability that you will deliver your services on time and in accordance with your budget.

22. The **two common financial risks** that pose the most serious threats to an organization's livelihood include:
    - ✓ Allowing a financial loss
    - ✓ The misuse of funds

23. The overall **purpose of internal controls over financial reporting** is to facilitate the preparation of reliable financial statements. Reliable financial statements must be materially accurate in all respects.

24. **Internal control over financial reporting serves many goals,** including:
    - ✓ Identifying material weaknesses
    - ✓ Bringing issues to light early
    - ✓ Ensuring compliance with industry standards
    - ✓ Employing competent personnel
    - ✓ Allowing for fewer "spot-checks" during an audit
    - ✓ Holding public organizations to the standards of private best practices

25. Organizations are responsible for **continuously monitoring and improving the effectiveness of internal control over financial reporting** and compliance with applicable laws and regulations.